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State Securities Regulators Remind Investors to Do Their Homework Before Investing in 529 College Savings Plans

WASHINGTON—As the year draws to a close, many investors are making decisions for their long-term financial goals, including saving for college through Section 529 College Savings plans. With increasing numbers of investors turning to these plans to help finance higher education costs, state securities regulators are concerned that they may not always have all the facts needed to make appropriate investment decisions.

“It pays to do your homework before investing in a College Savings Plan to educate yourself about the differences among the many plans offered today and choose the plan that’s right for you,” said Patricia D. Struck, Wisconsin Securities Administrator and President of the North American Securities Administrators Association (NASAA), the oldest international organization devoted to investor protection.

College Savings Plan assets and choices are growing at a fast pace, Struck said, noting that the most recent statistics from the College Savings Plan Network, an affiliate of the National Association of State Treasurers, show that state-sponsored 529 College Savings Plans have attracted more than $72.4 billion in assets.

These tax-advantaged savings plan are designed to encourage saving for future higher education costs by allowing contributions to grow tax-free. The money investors take out later from the plans is free from federal taxes as long as it is used to pay for qualified higher education expenses. Struck noted that the tax-free withdrawal provisions are scheduled to lapse in 2010 unless renewed by Congress.

Every state and the District of Columbia offer at least one 529 College Savings Plan. Although these plans can be purchased directly from the plan administrator, industry estimates show that as many as three out of four investors purchase their plan with the help of an investment professional, such as a financial adviser or broker.

“Regardless of how the plan is purchased, investors should have a basic understanding of the plan’s benefits, costs, and tax implications,” Struck said. To help investors select the most appropriate college savings plan, NASAA suggests four key questions investors should ask their financial professional before investing in a 529 College Savings Plan.

1. What are the plan’s tax implications? Tax treatment of college savings plan contributions, earnings, and withdrawals varies from one state to another. A number of states allow residents who participate in their own state’s plans to claim a partial or full state income tax deduction on contributions. In addition, many states provide residents with a state tax break on money taken out of 529 plans to pay qualified college expenses. Make sure you understand your state’s tax treatment of contributions to, and earnings distributions from, both in-state and out-of-state 529 plans.

2. What are the plan’s expenses? All College Savings Plans have associated costs, which can affect your investment return. Plans sold by financial professionals often cost more than plans purchased directly from the state. These extra costs generally stem from sales loads or other fees associated with share classes, annual distribution fees, including fees used to compensate the financial professional. You are entitled to a complete list of the costs associated with the plans – be sure to ask for it.

3. How are you compensated for selling these plans? Ask whether the adviser or broker receives a commission from any of the plans he or she is recommending. You also should be sure to ask about the plans offered by your home state to ensure that the plan you ultimately select best suits your needs.

4. Does an out-of-state plan’s performance or costs outweigh tax benefits of a home state plan? No two plans are exactly alike, and in some cases, if might make sense to consider an out-of-state plan. For example, if your in-state plan offers a tax deduction, but is saddled with high fees and poor performance, an out-of-state plan with lower fees and stronger performance may be the better choice.

“Before selecting any plan recommended by a financial professional, it is always wise to do your own research to double-check his or her advice,” Struck said.

For more information about College Savings Plans, NASAA, along with the College Savings Plan Network and the Investment Company Institute, offers a free brochure, “A Guide to Understanding College Savings Plans.”

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Understanding College Savings Plans

The following is adapted from a joint publication by NASAA; the College Savings Plan Network, an affiliate of the National Association of State Treasurers; and the Investment Company Institute, the national association of the investment company industry. Click here to download a PDF version of the full brochure.

Ways to Save for Education

To encourage greater savings for higher education expenses, federal and state lawmakers have developed innovative programs, such as qualified tuition programs, to make higher education financially accessible to more Americans.

In recent years, growing numbers of families have taken advantage of qualified tuition programs, commonly known as "529 plans" for the section of the tax code that authorizes them, as a way to help finance the future qualified higher education expenses of their children or grandchildren.

There are two types of 529 plans:

- ***prepaid tuition plans,*** which are set up to allow an individual to prepay a student's future tuition and fees at today's rates; and
- ***college savings plans***, which allow individuals to contribute to an account established to pay a student's qualified higher education expenses at any eligible educational institution.

Today, 49 states and the District of Columbia offer college savings plans and 17 states offer prepaid tuition plans. In addition, a group of close to 300 private U.S. colleges and universities offers a prepaid tuition program called the Independent 529 Plan, which allows investors to purchase discounted tuition at any of the colleges and universities that participate in the program.

College Savings Plans

College savings plans allow individuals to contribute to an account to pay a beneficiary's qualified higher education expenses, such as tuition, fees, books, supplies, and room and board. The value of college savings plans is based on the performance of the particular investments or investment strategy chosen by the contributor. As a result, college savings plans generally carry investment risk, which means the account value may increase or decrease depending on market conditions.

Contributions to college savings plans have been growing as the public becomes aware of their desirability as savings vehicles. For example, a survey of state plans indicates that assets held in 529 savings plans grew from $2.6 billion at year-end 2000 to $35.1 billion at the end of 2003. The asset growth was mostly attributed to an increase in the number of accounts, which rose to more than four million.

Many mutual fund companies manage college savings plans for states, and mutual funds are the most commonly used investment vehicle in these plans. At the end of 2003, 97 percent of 529 savings plan assets were invested in mutual funds. Each state's plan typically offers more than one investment option. These options typically include a portfolio of stocks and bonds whose percent composition changes automatically as the beneficiary ages; a portfolio with fixed shares of stocks and bonds; or individual portfolios with varying investment strategies.

Prepaid Tuition Plans

Prepaid tuition plans allow a parent, grandparent, or family friend to establish an account in the name of a student to "lock in" the cost of a specified number of academic periods or course units in the future at current prices, typically at the public colleges and universities located in the state sponsoring the program. For example, if an account holds shares worth two years' tuition, these shares will always be worth two years' tuition even several years later when tuition rates may have doubled. The account may be funded by a lump sum or periodic cash payments.

There are two main types of prepaid tuition plans - prepaid units and contracts. Prepaid unit plans sell units representing a fixed percentage of tuition. While the price of a unit may increase each year, once purchased, the unit remains valued at the same percentage of tuition it had when originally purchased. Under a contract plan, participants agree to purchase a specified number of years of tuition and mandatory fees and/or room and board. The purchase price depends on the age of the child, the type of payment (lump sum or installment), and the number of years or units purchased. Contract plans usually offer lower prices for younger children because the state has more time to invest the money.

Prepaid tuition plans provide a hedge against tuition inflation and enable the state to pool money to make long-range investments so that the earnings meet or exceed college tuition increases. Most prepaid tuition plans also have some type of guarantee from the state, ranging from full faith and credit obligations to a statutory guarantee. The specifics of prepaid tuition plans vary greatly from one state to another.

Income Tax Considerations

Contributions to 529 plans are made with after-tax dollars and any earnings grow tax-free at the federal level. Earnings withdrawn from 529 plans to pay for qualified higher education expenses are free from federal income tax for state-sponsored programs and programs of any eligible higher education institution. (The tax-free withdrawal provisions are scheduled to lapse in 2010 unless renewed by Congress.)

State-tax treatment of college savings plan contributions, earnings, and withdrawals vary from one state to another. A number of states allow residents who participate in their own state's plan to claim a partial or full state income tax deduction on contributions. In addition, many states provide residents with a state tax break on earnings distributions from 529 plans that are used to pay qualified college expenses. Check with your tax advisor for your state's tax treatment of contributions to, and earnings distributions from, both in-state and out-of-state 529 plans.

Selecting a 529 Plan

No two 529 plans are exactly alike. Before selecting either a prepaid tuition plan or a savings plan, you should consider what type of plan best suits your needs and obtain copies of its offering documents, which are provided free of charge by the plan and discuss the plan's features in detail. Rather than obtaining documents for just one plan, you may want to examine documents for a number of different plans, including those offered by your home state because they may offer benefits not available in another state's program. Doing so will enable you to compare the features offered by each of the programs and determine which plan best suits your needs. An excellent source for these materials is the College Savings Plans Network (CSPN) website (www.collegesavings.org).

Some investors may even consider both kinds of plans - a prepaid plan to cover tuition and fees and a savings plan to pay for additional expenses, such as room and board, books, and required supplies and equipment in connection with a postsecondary education.

Investors with questions about any of the plan's features should contact the state or the plan sponsoring the program. Most plans offer toll-free phone numbers to assist investors. Contact information for each of the states is available through the CSPN website.

When considering opening a 529 account you may want to consult with a financial adviser. If you consult with a financial adviser, you should ask whether the adviser has a relationship with any particular plan he or she is recommending. You also should be sure to ask an adviser about the plans offered by your home state to ensure that the plan you ultimately select is the plan that best suits your needs. If your financial adviser does not recommend your home state's plan, you should obtain and review information on your home state's plan before making an investment decision.

Selecting a 529 Plan: "Checklist"

Use this checklist to compare the features of different 529 plans. All of this information is readily available from the offering documents each plan provides.

- Who may open the account?
- Is there any limit on who qualifies as an eligible beneficiary?
- Are there any age requirements for the account owner or beneficiary?
- Can I change the account beneficiary? If so, are there any fees assessed by the plan for the change?

- Is the plan available to residents in my state?
- At which colleges, universities, or vocational schools may withdrawals be used? (For example, if the 529 plan is a prepaid tuition plan there may be limits on the institutions whose tuition is covered in full.)
- Do I have to name a specific school when buying a prepaid tuition plan? If the plan is school-specific, what happens if the student decides to attend a different school or isn't admitted by the school?
- Are prepaid tuition benefits guaranteed by the state?
- How are prepaid plan benefits indexed to tuition inflation? Are they guaranteed to equal actual tuition increases, the state average increase, or a projected increase?
  Does the plan impose any minimum contribution requirements?
- Is there a limit on how often I can invest in the account or on how much I can annually invest in the account?
- What is the maximum amount that I can invest in the account over the life of the account?
- What expenses are covered by plan withdrawals?
- What is the plan's refund policy?
- Are there any special incentives for state residents?
- What fees are associated with my account?
- Is there an account minimum I must maintain to avoid certain fees?
- Can I buy the plan directly from the state or plan sponsor, or must it be purchased through a broker-dealer?
- If I purchase the plan through a broker-dealer, will the broker-dealer impose any additional fees in connection with opening the account?
- Can I change how my money is invested?
- If I consult with a financial adviser, what relationship, if any, does that adviser have with the plan he or she is recommending?
- What investment options are offered by the plan?
- What are the risks associated with each of the investment options?
- Are any of the investment options "age-based" such that the portfolio will be automatically adjusted as the beneficiary gets older?
- What has been the performance of the various investment options offered by the plan?
- Does my state offer any tax advantages for either contributions made to the account or withdrawals from the account?
- Does the plan limit how soon I can begin taking withdrawals from the account?
- Does the plan impose any penalties for withdrawals from the account or impose any account termination fees?
- What customer services does the plan provide (toll-free phone numbers, online account information, regular bulletins or mailings)?
- What happens to existing investments and future investments if the investment manager is changed by the state?
- What if my child does not pursue a postsecondary education?

Frequently Asked Questions

Are prepaid tuition plans and college savings plans different?
Yes. With a prepaid tuition plan, parents, grandparents, and others essentially "lock in" today's tuition rates, and the program will pay out future college tuition at any of the state's eligible colleges or universities (or a payment to private and out-of-state institutions). A college savings plan is an investment program that allows participants to invest in a special account designated for qualified higher education expenses. In general, college savings plans offer a rate of return that depends on the performance of the plan's investments. As such, the value of a college savings plan account may increase or decrease over time.

How much can be contributed to a 529 plan?
Each state sets its own contribution limit under federal regulations. For a prepaid tuition plan, the maximum contribution is the amount necessary to prepay the number of years or units of tuition offered by the state. This amount will vary from state to state. A majority of states with college savings plans have maximum contribution limits of more than $200,000. These limits also may be adjusted annually for inflation. In 2004, individuals can contribute up to $55,000 in one year for each beneficiary - or $110,000 from married couples - without incurring federal gift taxes, as long as no further gifts to or for that individual are made during the next five years.

Who can contribute to 529 plans?
Generally an account holder can open an account on behalf of any student or potential student. For example, grandparents can save on behalf of grandchildren. Even someone who is not a family member can open a 529 plan account for an unrelated child or adult.

Can I open more than one account in the name of the same student?
Yes. You can open multiple accounts for the same student, and more than one person can contribute to a college savings plan for the same beneficiary. However, a state's maximum contribution limit would limit the total amount that may be invested for a single beneficiary under that state's program, regardless of how many accounts are held in the beneficiary's name.

Do 529 plans vary from state to state?
Yes. Each state with an existing plan offers various investment options specifically designed to save for education expenses. Determining which plan to invest in will depend on individual circumstances, taking into account several factors associated with the programs, such as fees, expenses, investment options, and performance. In addition, investing in the plan offered by an individual's own state might lower that individual's state income tax burden, depending on the laws of the state. Participants may transfer 529 assets from one state's plan to another, tax-free, once every 12 months, or more often if there is also a change to the account's beneficiary.

Can I have more than one student in a single account?
No. When you invest in a college savings plan or prepaid plan you are investing on behalf of a designated individual beneficiary. You can transfer your account to any member of the beneficiary's family, as defined by the Internal Revenue Service, without incurring any taxes or penalties.

When can a 529 plan be opened?
The answer depends on the type of 529 plan being opened. A college savings plan generally can be opened anytime after a child is born. Most prepaid tuition plans, however, have a set enrollment period established by the state during which new accounts may be opened and have age limits for the beneficiary.

Where can 529 college savings plan withdrawals be used?
Withdrawals from 529 savings plans can be used to pay for qualified higher education expenses at any college, university, vocational school, or other accredited postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. This includes virtually all accredited public, nonprofit, and privately owned profit-making postsecondary institutions.

What expenses can 529 plan withdrawals be used for?
Withdrawals from 529 savings plans can be used penalty-free only to pay for qualified higher education expenses, such as tuition and fees; the cost of books, supplies, and other equipment; and in some situations the cost of room and board. (The cost of room and board may be a qualified higher education expense if the designated beneficiary is enrolled at least half time at an eligible educational institution.) Section 529 prepaid tuition plans typically cover tuition and required fees. Unlike the Independent 529 Plan, some states' prepaid plans may also cover room and board.

What if my child does not pursue a postsecondary education?

You may request a refund, and the account will be refunded according to the policy of your specific 529 plan. For 529 savings plans, the refund would include any earnings in the account. Under federal law, there may be income tax consequences including a refund penalty of 10 percent, except in the case of the student's death, disability, or receipt of a scholarship. In lieu of requesting a refund, you may choose either to hold the 529 plan investment until a later date when the student may decide to attend college, or transfer the benefits to another member of the student's family.

Will 529 savings plans affect a student's chance to qualify for financial aid?
Financial aid treatment of investments changes through the years so it is impossible to know how assets will be treated in the future. Typically, however, any investment may impact a student's eligibility for need-based financial aid. In addition, it is uncertain as to how much or what types of financial aid will be available to families in the future. You should contact the financial aid office of your local college or university for specific information on its financial aid treatment of 529 accounts.

What happens if I move from one state to another?
You have a choice of leaving your money in the existing plan or rolling it over into the plan of your new state. Assets of one 529 plan can be transferred tax-free to another 529 plan for the same beneficiary once during a 12-month period. There may, however, be state tax implications when you transfer from one 529 plan to another. Also, if you decide against changing plans after moving, you may lose any state tax deduction on future contributions and state tax exemptions on withdrawals made to the plan offered by your former home state. (The money invested will still grow tax-deferred.) Your new state also may offer favorable tax treatment for investments made in its plan. As a result, when moving, you should investigate the tax implications of each state's plans. An account owner does have the option of establishing accounts in more than one state for the same beneficiary.

Where can I find more information on 529 plans?
Many mutual fund company websites provide information on education savings programs they offer. Individuals seeking additional information on prepaid tuition plans and college savings plans may want to visit the website of the College Savings Plans Network, an affiliate of the National Association of State Treasurers, at www.collegesavings.org. Additional information about 529 plans and their regulation is available through the websites of the Municipal Securities Rulemaking Board (www.msrb.org), which regulates the offer and sale of such plans, and of the NASDR (www.nasdr.org), which regulates broker-dealers.

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